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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 000528

SIPDIS

DEPT FOR EUR/RUS, FOR EEB/ESC/IEC GALLOGLY AND WRIGHT
EUR/CARC, SCA (GALLAGHER, SUMAR)
DOE FOR HEGBURG, EKIMOFF
DOC FOR JBROUGHER

E.O. 12958: DECL: 02/19/2019
TAGS: EPET ENRG ECON PREL RS
SUBJECT: RUSSIA/CHINA OIL DEAL: CLEAR AS MUD

REF: MOSCOW 199

Classified By: Econ MC Eric T. Schultz for Reasons 1.4 (b/d)

Summary

¶1. (C) Following months of negotiations, Russian and Chinese state-owned corporations recently concluded a $25 billion loans-for-oil deal. The China Development Bank will provide Rosneft with $15 billion and Transneft with $10 billion at a relatively low interest rate, while the two Russian companies will provide the Chinese National Petroleum Corporation with 15 million tons of oil per year for 20 years. The parties involved have not released information on a number of key elements (including pay-out provisions and oil prices), leaving analysts guessing as to the relative merits of the agreement for each side. The deal would appear to provide a financial lifeline to the credit strapped Russian companies. However, the reported benefit to China, the right to buy oil later at or near market prices, seems limited unless, as many experts speculate, the deal includes unspecified commercial and/or political benefits. End summary.

What We Know

¶2. (C) At this point, despite numerous calls and meetings, we have only been able to confirm a limited amount of information regarding the recent loans-for-oil deal between Rosneft and Transneft on the Russian side, and the China Development Bank (CDB) and the Chinese National Petroleum Corporation (CNPC) on the Chinese side. According to various sources, the deal consists of at least three separate agreements--an Intergovernmental Agreement (IGA), a CDB-Transneft agreement and a CDB-Rosneft Agreement. Some sort of deal covering the oil supplies will also likely be needed between the Russian companies and the Chinese National Petroleum Corporation (CNPC).

¶3. (C) The IGA: The first agreement is an Intergovernmental Agreement (IGA) between the Russian and Chinese governments. According to Transneft International Affairs advisor Oleg Pillipets, the IGA provides the political and legal framework for the deal. It was not actually "signed" by the two countries, only "initialed." Pillipets said that the primary purpose of the IGA was to allow for the efficient movement of goods, labor, and other personnel across the China-Russia border in order to complete the oil pipeline link between the

two countries.

¶4. (C) The Rosneft Deal: According to the Rosneft press release, the deal between the CDB and Rosneft is a loan package worth $15 billion in return for oil supplies in an unspecified amount and at an unspecified price over the next 20 years. (N.B. Presumably Rosneft will be supplying the bulk of the 15 million tons of oil referred to in the initial announcement.) Rosneft Vice President for Finance Peter O'Brien told us that more details would be forthcoming once contracts are "signed and corporate approvals in place;" implying the deal is less final than Rosneft's own press release reported. O'Brien is quoted in press reports saying Rosneft would use some of the loan proceeds to refinance portions of its $21 billion in debt, of which $8.5 billion comes due this year, with an additional $7.3 billion coming due in the next two years. O'Brien also indicated the company might use some of the money on acquisitions and/or to pay dividends.

¶5. (C) The Transneft Deal: According to press reports and conversations with Transneft's Pillipets, the China Development Bank-Transneft agreement is a separate agreement that includes a $10 billion loan from CDB to Transneft. Pillipets informed us during a February 19th conversation that he had not seen the final version of the contract, but that, under an earlier draft, Transneft would be responsible not only for completing all the necessary infrastructure to deliver oil to China, but also for procuring oil for sale to China. The amount of oil to be delivered, he added, would depend on the market price of oil--if oil prices are high,

then less oil would be needed to cover Transneft's debt.

¶6. (C) Pillipets said Transneft would use its loan to complete the first phase of the East Siberia-Pacific Ocean (ESPO) pipeline, as well as the related infrastructure and connections to connect ESPO to Russian oil fields. He said Transneft expects to complete phase 1 of ESPO, to the city of Skovorodino in the Russian Far East, by the end of 2009. He also expects deliveries of oil to China, through a spur south from Skovorodino to the Chinese city of Daqing, to begin in the first half of 2010.

¶7. (C) The Chinese National Petroleum Corporation: Various press releases indicate that the Chinese National Petroleum Corporation will receive 15 million tons of oil per year as a result of contracts related to this deal. The oil is expected to come from Rosneft's Vankor field via Transneft's ESPO line to China and to be supplied/paid for by both Russian companies.

¶8. (C) Sector experts with whom we spoke noted that the lack of clarity as to the details of the deal and the various agreements was a red flag. ExxonMobil VP Zeljko Runge (protect), for instance, said he did not believe Rosneft would be able to deliver the promised oil from Vankor. He noted that Vankor is already behind schedule and cannot produce oil economically at an oil price of less than $70 per barrel. He predicted that Rosneft would have to write down most of the capital expenditures for the field.

¶9. (C) BP's government and public affairs manager, Anton Mifsud-Bonnici (protect), told us February 20 that he, too, does not believe Vankor can produce oil economically at today's prices. (N.B. BP owns 1% of Rosneft stock.) Long-time market analyst and fund manager Paul Collison (protect) told us he considers capital costs related to Vankor as "sunk costs" and does not incorporate them into his models for the field's cash flow. As a result, he said he viewed the deal generally positively for Rosneft, but cautioned that there is a good chance the Russian side could "screw this up."

What We Don't Know

¶10. (C) As Vladimir Konovalov, head of the Petroleum Advisory Forum (the association of Western oil companies in Russia), stated during our conversation, "put unelected political leaders keen on lining their pockets in a room together to hammer out a multi-billion dollar deal and, voila, you have a non-transparent deal surrounded by white smoke." While some details of the deal are likely to become clear over time, others may remain forever hidden.

¶11. (C) Disbursement: While press releases give a maximum amount of funding to be provided to each Russian company, they do not give any details on how these lines of credit would be accessed. In particular, the publicly available information is silent on whether the Russian companies will be able to access the full amount this year, or whether the funds will be released in tranches and, if so, under what conditions. Shell's manager of new business development in Russia, Froede Linge (protect), told us February 17 he would be shocked if China had agreed to release the loan funds to Transneft and Rosneft in a lump sum. "How can you be sure they would deliver?" he asked. What would happen, he wondered, if next year Transneft had not completed the ESPO and Rosneft was not ready to deliver oil from the Vankor field?

¶12. (C) The Interest Rate: According to Rosneft's press release, credit will be provided at "market rates." The companies themselves have not confirmed any specific figure. However, press reports and various privately published analyses put the rate in the range of 5% to 6%, well below the current market rate for the handful of Russian companies that are fortunate to get access to foreign capital in the current tight credit markets.

¶13. (C) Repayment Terms and the Price of Oil: Press releases clearly link loan repayment to oil supply contracts. The

total amount of oil expected (15 million tons per year for 20 years) and the amount of credit available ($25 billion between the two Russian companies) are known. However, the exact modalities linking the oil and repayment are unknown, with the key variable being the price of the oil. Rosneft announced in its press release that the two Russian companies would sell oil at "fair" prices, "based on market quotes." Initial back of the envelope calculations of $20 a barrel (15 million tons divided by $25 billion) are almost certainly wrong but so are claims in the press that, without any supporting evidence, put the price in the range of $72 per barrel.

¶14. (C) While industry press and local experts continue to speculate, none of the parties have been willing, thus far, to confirm any of the rumors relating to price. The more credible analysts, however, generally agree with a press report that cited confidential sources as saying the oil price will be the Brent price minus $3. This tracks with comments from Konovalov, who told us February 26 that he had heard "rumors" that the price was to be "a few dollars" below Brent. Fund manager Paul Collison told us on February 25 that he understands the oil will be sold at a price "tied closely to market prices," though he was unsure of the exact loan terms. Finally Transneft's Pillipets, who emphasized that his information comes from an earlier draft of the contract and that he had not seen the final document, said the oil price was to be at "market prices at the port of Kozimo at the time of delivery."

What This Means

¶15. (C) Credit for the Credit-Starved: Although few details

are available and speculation abounds, one clear take-away is that the deal will provide needed cash to two credit-starved Russian companies. Many investment house analysts believe that, at the least, Rosneft and Transneft will now have cash with which to get through a very tough year during which Russian companies are likely to be all but frozen out of world credit markets. With this cash infusion, Transneft should be able to finance the ESPO project, while Rosneft should be in a position to deal with its short-term debt problem.

¶16. (C) Politics behind the Deal: In describing Russia's calculations in the deal, BP's Mifsud-Bonnici said that economic considerations "don't matter to the people running the show" and he speculated that "there must be political and military considerations related to the deal" that we may never know. Mifsud-Bonnici said he did not believe it was coincidence that the deal was announced a day before the launch of the Sakhalin 2 LNG terminal, "they are showing the world that they are paying attention to the east." Collison also suggested that the deal is a demonstration of a new Russian emphasis on the east.

COMMENT

¶17. (C) We may never know all the details of the agreements reached between Russia and China as part of the loans-for-oil deal. However, we are extremely dubious that political considerations would have led the Chinese to agree to provide low-interest loans to cash-starved Russian companies in tight credit conditions in exchange for the right to buy oil at or near market prices in the future. That hardly seems like a good deal for China: there are either strings attached that benefit China or the price will be substantially below market.
BEYRLE